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PLR-143191-13

Date: March 18, 2014

Legend:

Taxpayer =

Group =

State =

Advisor =

Dear :

This responds to your request for a ruling dated October 9, 2013, and subsequent correspondence, submitted on behalf of Taxpayer. Taxpayer requests a ruling that income and gain derived from CPI Swaps (as defined below) will constitute other income derived with respect to Taxpayer's business of investing in stock and securities and therefore will constitute qualifying income under section 851(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code").

Facts:

Taxpayer is a series of Group, a State corporation registered as an open-end management investment company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the "1940 Act"). Taxpayer's investment objective is to seek inflation protection and maximize total returns. Taxpayer's strategy is to invest directly and indirectly through other mutual funds ("underlying funds") in a combination of non-inflation and inflation-protected debt securities and derivative instruments. Taxpayer and each underlying fund has elected and qualified, and will continue to qualify, or, if it has not yet commenced operations, will elect and qualify as a regulated investment company ("RIC") under subchapter M of the Code. Taxpayer is treated as a

separate corporation under section 851(g). Advisor serves as investment manager to Taxpayer and the underlying funds.

Taxpayer may enter into inflation swap agreements to manage or reduce the risk/effects of inflation with respect to Taxpayer's direct investments in (i) shares of the underlying funds and (ii) non-inflation indexed bonds. Taxpayer will enter into inflation swap agreements that use the U.S. Consumer Price Index Urban Non-Seasonally Adjusted (or any successor index) ("CPI-U NSA") as the price index ("CPI Swaps"). The CPI-U NSA is published by the U.S. Bureau of Labor Statistics and is regarded as a measure of inflation. The CPI-U NSA is a non-seasonally adjusted measure for estimating inflation by referencing changes in the price levels for urban consumers of a standard basket of goods and services. The CPI Swaps are fixed maturity derivatives in which the counterparty receives the "realized" rate of inflation as measured by the applicable CPI over the life of the swap. Some of the CPI Swaps involve two or more payments over the term of the swap, while other CPI Swaps will have a "bullet" structure, where all cash flows are exchanged at maturity.

Taxpayer represents that each of the non-inflation indexed bonds and the shares of an underlying fund held by Taxpayer qualify as a "security" or "stock" under section 851(b)(2). The non-inflation indexed bonds that Taxpayer and the underlying funds may invest in include: U.S government obligations, U.S. government agency obligations, corporate debt obligations, bank obligations, commercial paper, repurchase agreements, foreign government and agency obligations, supranational organization obligations, Eurodollar obligations, and foreign issuer obligations. Certain of the non-inflation indexed bonds held directly by Taxpayer or indirectly through the underlying funds will be denominated in a foreign currency and hedged back into U.S. dollars ("foreign currency investments"). Taxpayer represents that the CPI Swaps are intended to manage the effects of only the U.S. dollar inflation risk with respect to the foreign currency investments. Taxpayer further represents that the CPI Swaps are the sole protection entered into by Taxpayer to manage such U.S. dollar inflation risk with respect to the foreign currency investments.

Taxpayer is an actively managed RIC, and, as such, CPI Swaps are entered into, maintained, and exited based upon on-going portfolio management decisions. Taxpayer has represented that the notional amount of the CPI Swaps will not exceed an amount reasonably calculated to reduce Taxpayer's level of inflation risk with respect to Taxpayer's direct investments in (i) shares of the underlying funds and (ii) non-inflation indexed bonds. Taxpayer further represents that the notional amount of the CPI Swaps will not exceed the sum of the total fair market value of Taxpayer's direct investments in (i) shares of the underlying funds and (ii) non-inflation indexed bonds.

Law:

Section 851(a) defines a RIC, in part, as a domestic corporation registered under the 1940 Act as a management company.

Section 851(b) limits the definition of a RIC to a corporation meeting certain election, gross income, and diversification requirements.

Section 851(b)(2) provides that a corporation shall not be considered a RIC for any taxable year unless it meets an income test (the “qualifying income requirement”). Under this test, at least 90 percent of its gross income must be derived from certain enumerated sources (such income is referred to as “qualifying income”).

Prior to the enactment of the Tax Reform Act of 1986 (the “1986 Act”), section 851(b)(2) identified qualifying income as “dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stocks or securities.” Section 851 did not contain its own definition of the term “securities,” but section 851(c)(5) provided that, for the purpose of section 851(b)(3) (the “asset diversification test”), “[a]ll other terms shall have the same meaning as when used” in the 1940 Act.¹

The 1986 Act expanded the meaning of qualifying income under section 851(b)(2) in a number of ways: (1) by adding an explicit cross-reference to the definition of “securities” in the 1940 Act; (2) by adding gains from the sale or other disposition of foreign currencies; and (3) by adding an “other income” provision. As so amended, qualifying income under section 851(b)(2) includes, in relevant part, –

. . . dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies. . . .

Section 2(a)(36) of the 1940 Act defines the term “security” as –

. . . any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group

¹ Section 851(c)(5) of the Code was redesigned as section 851(c)(6) by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, section 331(c) (10-22-2004).

or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Analysis:

In analyzing whether a derivative financial instrument generates qualifying income under the “other income” clause of section 851(b)(2), we examine the relationship between the income or loss generated by the derivative and the RIC’s business of investing in stock, securities, or currencies. In conducting this analysis, we must also consider the legislative history accompanying the 1986 enactment of the other income provision to determine Congressional intent.

Relationship of Income from the CPI Swaps to the RIC’s Business of Investing in Stock, Securities, or Currencies

Income and gain from the CPI Swaps may be other income that is qualifying income to Taxpayer, if the income and gain is derived with respect to Taxpayer’s business of investing in stocks, securities, or currencies. As noted above, Taxpayer represents that the non-inflation-indexed bonds and the shares of the underlying funds it holds are “securities” and “stock,” respectively, under section 851(b)(2).

Taxpayer represents that its purpose in investing in CPI Swaps is to protect against losses in the value of its non-inflation indexed bonds and shares of the underlying funds due to inflation, and further that its position in the CPI Swaps is reasonably calculated to reduce Taxpayer’s inflation risk with respect to such investments. The inflation indexed payments that Taxpayer receives under the CPI Swaps are intended to reduce the effects of inflation on Taxpayer’s direct investments in (i) shares of the underlying funds and (ii) non-inflation indexed bonds. The payments that Taxpayer expects to receive from the CPI Swaps and corresponding decrease in the inflation-adjusted value of Taxpayer’s direct investments in (i) shares of the underlying funds and (ii) non-inflation indexed bonds demonstrate the requisite relationship between the income generated by Taxpayer’s positions in CPI Swaps and its business of investing in stock and securities.

Taxpayer has represented that the notional amount of the CPI Swaps generally will not exceed an amount reasonably calculated to reduce Taxpayer’s level of inflation risk with respect to its direct investments in (i) shares of the underlying funds and (ii) non-inflation indexed bonds. This representation will be satisfied if the total notional amount of Taxpayer’s CPI Swaps generally will not exceed an amount equal to the total

fair market value of Taxpayer's direct investments in (i) shares of the underlying funds and (ii) non-inflation indexed bonds.

Controlling Statutory Language

In amending section 851(b)(2) in 1986, Congress inserted parenthetical language that specifically enumerated gains from futures contracts (as well as gains from options and forward contracts) as a type of income that may constitute other income derived with respect to a RIC's business of investing in stock, securities, or currencies. Congress specifically noted that the Service had previously ruled favorably under section 851(b)(2) on income from futures contracts (131 Cong. Rec. 24570-71 (1985)), creating a strong inference that the statutory language should be interpreted in a manner consistent with those prior rulings.

The pricing and economics of the CPI Swaps at issue are similar to those of the futures contracts enumerated in section 851(b)(2) and discussed in the legislative history to that provision. Therefore, income from the CPI Swaps falls within a category of income which Congress intended to include as qualifying income under the other income provision if derived with respect to the RIC's business of investing in stock, securities, or currencies.

Passive Nature of Income

The types of investments expressly permitted under the Code for RICs are passive in nature. Congress has explained that the favorable RIC tax provisions are intended for passive investment entities that do not engage in active business and that a RIC's investments should be limited to income from stocks and securities, as opposed to other property. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (1987), at 377. A letter by J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy) ("the Mentz letter"), explained the fundamental policy served by the qualifying income requirement:

. . . First, income qualifying under section 851(b)(2) should be limited to income from property held for investment, as opposed to property held for sale to customers in the ordinary course of business. Second, income qualifying under section 851(b)(2) should be limited to income from stocks and securities, as opposed to other property. . . For example, under the second limit, we would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading is to hedge a related stock investment.

132 Cong. Rec. 4048 (1986) (remarks from Senator Armstrong, inserting letter of J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy), dated February 5, 1986, to Rep. Flippo).

The trading of securities held by a RIC for investment is treated as passive in nature. Id. Here, the income and gain generated by Taxpayer from investments in the CPI Swaps are also passive in nature, similar to those generated by investments in stock and securities within the meaning of section 851(b)(2).

Policy Limitation on Investment in Commodities

As noted above, Congress has explained that a RIC's investments should be limited to income from stocks and securities. With respect to commodities, the Mentz letter states that “. . . we would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading is to hedge a related stock investment.” Id.

Although the CPI-U NSA, the underlying referent for the CPI swaps, includes the value of certain baskets of commodities in measuring the average change in prices over time of goods and services of urban consumers, the annual percentage change of the CPI-U NSA is predominantly used as a measure of inflation. Thus, a position in a derivative referencing the CPI-U NSA is not predominantly an indirect investment in commodities.

Conclusion:

Assuming that the non-inflation indexed bonds and the shares of underlying funds are “stocks” or “securities” under section 851(b)(2), we rule that the income and gain derived from the CPI Swaps constitute other income derived with respect to the Taxpayer's business of investing in stock and securities within the meaning of section 851(b)(2) of the Code, provided that the notional amount of the CPI Swaps generally will not exceed an amount reasonably calculated to reduce Taxpayer's level of risk with respect to its investments in (i) shares of the underlying funds and (ii) non-inflation indexed bonds. This will be satisfied if the total notional amount of Taxpayer's CPI Swaps generally will not exceed an amount equal to the total fair market value of Taxpayer's investments in (i) shares of the underlying funds and (ii) non-inflation indexed bonds.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed whether Taxpayer otherwise qualifies as a RIC under part I of subchapter M of chapter 1 of the Code, whether Taxpayer's investments constitute securities under section 851(b)(2), or whether gains generated by Taxpayer's CPI Swaps may also constitute qualifying

income under section 851(b)(2) as gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the 1940 Act).

This ruling is directly only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Andrea M. Hoffenson
Assistant to the Branch Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions and Products)